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No. 98-1395

In the
Supreme Court of the United States
October Term 1998

POLAROID CORPORATION,
Petitioner,

v.

MURIEL K. OFFERMAN, Secretary of Revenue
of the State of North Carolina,
Respondent.

On Petition for a Writ of Certiorari to the
Supreme Court of North Carolina

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

I. Whether the North Carolina Supreme Court's interpretation and application of the "functional test" of the statutory definition of "business income" in the North Carolina corporate income tax act to include in petitioner's apportionable income damages recovered from Kodak's infringement of its patents violates the unitary business principle of the Due Process and Commerce Clauses of the United States Constitution, where the patents served an operational function in petitioner's unitary business, part of which was conducted in this state, and where the patent infringement litigation was related to petitioner's business activities in North Carolina.

II. Whether North Carolina's apportionment scheme, by including in petitioner's apportionable income damages designed to compensate it for over fifteen years of lost profits, violated the Due Process or Commerce Clause by taxing income which could not in fairness be attributed to petitioner's activities within North Carolina.

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Respondent, Muriel K. Offerman, Secretary of Revenue of the State of North Carolina, respectfully requests that this Court deny the petition for writ of certiorari, seeking review of the North Carolina Supreme Court's decision in this case. That opinion is reported at 349 N.C. 290, 507 S.E.2d 284 (1998).

STATEMENT OF THE CASE

A. MATERIAL FACTS

Petitioner, Polaroid Corporation ("Polaroid"), develops, manufactures and sells photographic equipment. As one of the world's predominant manufacturers of instant photographic equipment, Polaroid continually develops and refines methods of designing and marketing those products. It has obtained an extraordinary number of patents, thereby protecting its dominance in the market.

In 1976, Polaroid instigated a costly and protracted patent infringement lawsuit against Eastman Kodak Company ("Kodak"), seeking injunctive relief and damages. The litigation spanned fourteen years. By the lawsuit, Polaroid sought to recover lost profits it would have earned had Kodak's unlawful competition not occurred. In this "but for Kodak" world, it would have enjoyed a lawful monopoly from 1975 through early 1991, when the final Polaroid patent would have expired. *Polaroid Corp. v. Eastman Kodak Co.*, 16 U.S.P.Q.2d 1481, 1489 (D. Mass. 1990). In 1991, Polaroid received the sum of $924,526,554 from Kodak as damages for Kodak's infringement of Polaroid's camera and film patents.

For North Carolina corporate income tax purposes, Polaroid classified the total damage award as "nonbusiness income" on its 1991 tax return, allocating it entirely to

Massachusetts, the state of its commercial domicile. In Massachusetts, however, which does not distinguish between business and nonbusiness income, Polaroid treated the entire damage award as apportionable income, apportioning it among all states in which it did business, thus paying taxes on only a fraction of the award in Massachusetts.[1] Over the many years of the lawsuit, Polaroid deducted all expenses associated with the patent infringement litigation as business expenses against its apportionable income for North Carolina tax purposes, depressing the amount of taxes paid to this state for those years.

B. THE DECISION BELOW

Polaroid sued the North Carolina Secretary of Revenue for a refund of corporate income taxes on the grounds that the damage award was not "business income" under North Carolina's statutory definition of that term. N.C. GEN. STAT. § 105-130.4(a)(1) provides:

> 'Business income' means income arising from transactions and activities in the regular course of the corporation's trade or business and includes income from tangible and intangible property if the acquisition, management and/or disposition of the property constitute integral parts of the corporation's regular trade or business operations.

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[1] The state court's finding that the damage award was taxable in North Carolina therefore did not result in multiple taxation.

At the heart of the dispute was whether the statutory definition set forth one or two tests for business income. Polaroid had argued that the statute contained only a single test, referred to as the "transactional test," arising from the first clause of the definition. The Secretary contended that the second clause of the statutory definition gave rise to an independent "functional test." North Carolina's definition of "business income" is essentially identical to that in the Uniform Division of Income for Tax Purposes Act ("UDITPA").

Joining the mainstream of opinion,[2] the North Carolina Supreme Court, in a unanimous decision, held that the definition of business income under the North Carolina corporate income tax act includes the functional test. The court found that Polaroid's recovery from the Kodak lawsuit "provided Polaroid with income from assets--the patents--which are integral parts of its regular trade or business operations." *Polaroid Corp. v. Offerman*, 349 N.C. 290, 296

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[2] Petitioner's contention that there is a "serious split among the states" regarding this issue as summarized in the opinion below is erroneous. Petition p. 8, n.1. While it is true, as the opinion states, that the courts of Iowa, Kansas and Tennessee had interpreted the UDITPA definition of business income as containing only the "transactional test," petitioner fails to inform the Court that "after these decisions, the legislatures of those states promptly amended their respective tax statutes to explicitly include the functional test within their definition of business income." *Polaroid*, 349 N.C. at 295. The North Carolina Supreme Court further observed that its interpretation of the statutory definition was consistent with state court opinions from Arkansas, Illinois, Oregon, Pennsylvania and New Mexico. *Id.* at 295-296, 298-300.

(1998). The court thus rejected Polaroid's factual contention that the income at issue arose not from the patents, but rather from the lawsuit, which petitioner had characterized as a "unique chose in action."

The opinion held:

> It is undisputed that the Kodak judgment was designed to compensate Polaroid for Kodak's infringement of its patents. Moreover, it is undisputed that Polaroid's patents were an integral part of its regular trade or business operations. In fact, Polaroid's primary source of income results from the sale of products based on its patents. Therefore, given that the Kodak judgment constituted 'income' stemming from the 'acquisition, management and/or disposition' of Polaroid's integral assets and in lieu of normal marketplace sales, we hold that it should be taxed as business income for North Carolina corporate income tax purposes.

Polaroid, 349 N.C. at 308.

The court rejected Polaroid's broad and undeveloped allegations that interpretation of the statutory definition of business income to include the damage award in apportionable income would violate the United States Constitution. *See infra.*

REASONS TO DENY THE PETITION

I. THE NORTH CAROLINA SUPREME COURT DID NOT DECIDE AN IMPORTANT QUESTION OF FEDERAL LAW IN A WAY THAT CONFLICTS WITH APPLICABLE DECISIONS OF THIS COURT.

This is not an appropriate case for granting a writ of certiorari. The question before the North Carolina Supreme Court involved only a question of state law--the proper interpretation of North Carolina's statutory definition of "business income." This statutory construction issue raises no important federal question reviewable by this Court. Moreover, the opinion below properly stated and applied relevant precedent of this Court to find that classification of the damage award as business income did not offend the Constitution under the unique facts of this case. Petitioner seeks "amplification of this Court's unitary business principle." Petition p. 7. "The legal principles defining the constitutional limits on the unitary business principle are now well established," however, and need no further fine-tuning. *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 176 (1983). Petitioner presents no grounds for the Court to accept this case for plenary review.

A. THE COURT BELOW PROPERLY STATED AND APPLIED APPLICABLE DECISIONS OF THIS COURT.

Addressing Polaroid's broad constitutional allegations,[3] the North Carolina Supreme Court properly reiterated the familiar principle that:

> [T]o successfully challenge the constitutionality of a state's apportionment scheme, a taxpayer must

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[3] Polaroid's entire argument to the state court on this issue consisted of the following single paragraph:

> Statutes should be interpreted to avoid unconstitutionality, and taxation of the damages would violate the United States Constitution. States are allowed to tax only income earned within their borders. In the case of multistate corporations, this means that the state can tax only business income that is properly apportioned among the states in which the business is conducted. If the state attempts to tax nonbusiness income as apportionable business income, it violates the U.S. Constitution's Due Process Clause by taxing income that it has no power to tax, and the Commerce Clause by overtaxing corporations doing business in interstate commerce. *See, Allied-Signal, Inc. v. Director,* 504 U.S. 768 (1992); *Gulf Oil Corp. v. Clayton*, 267 N.C. 15, 23 (1966) (holding that state cannot constitutionally tax income of a single corporation unless it is attributable to "business activities" in the state).

Plaintiff-Appellee's New Brief p. 30.

> demonstrate by 'clear and cogent evidence' that the scheme results in extraterritorial values being taxed.

Polaroid, 349 N.C. at 314 (citing *Butler Bros. v. McColgan*, 315 U.S. 501, 507 (1942)). The court concluded that "Polaroid has failed to provide such evidence." *Id.*

As additional justification for taxation, the lower court found that:

> North Carolina can constitutionally tax Polaroid's recovery from the Kodak lawsuit under the unitary business principle. According to the unitary business principle, a state may tax a corporation on an apportionable share of the multistate business carried on in part in the taxing state.

Id. (citing *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 778 (1992)).

The court correctly noted that:

> In order to exclude certain income from the apportionment formula, the corporation must prove that the income was earned in the course of activities unrelated to those carried out in the taxing State.

Id. (quoting *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207, 223 (1980)).

Contrary to petitioner's contention, the decision below did *not* find that the lawsuit and the recovery "had no connection with North Carolina." *See* Petition p. 5. Rather, the court specifically determined that:

> In this case, Polaroid's judgment from the Kodak lawsuit constitutes *income earned from activities related to North Carolina*. The judgment partly represents profits which Polaroid would have earned absent Kodak's infringement. Those profits would have been properly considered apportionable income had they been earned in the normal manner. The fact that they were received in the courtroom instead of the marketplace is irrelevant.

Id. (emphasis added).

The opinion had earlier noted that Kodak's infringement constituted a potentially devastating threat to the business of Polaroid, and that the protection of Polaroid's patents was crucial to its ability to carry on its regular trade or business operations, part of which were conducted in North Carolina. As the decision recognized, Polaroid instigated the patent enforcement lawsuit to protect its fundamental business assets, wherever they might be used, and to preserve its lawful monopoly. The patents and the patent infringement litigation were therefore inextricably linked to Polaroid's business activities within this state.

In ruling that the damage award was "business income," the court below noted this Court's jurisprudence indicating that damages recovered by a patentee under 35 U.S.C. § 284 constitute compensation for any pecuniary loss suffered and are intended to return the patentee to the same condition it would have been in had the infringement not occurred. *Id.* at 306 (citing *Aro Mfg. Co. v. Convertible Top Replacement Co.*, 377 U.S. 476, 507 (1964)). The lower court found particularly significant this Court's statement that, under the current statutory framework, "an infringed-upon patentee can only recover its *damages* as opposed to recovering profits obtained by the infringer or other monies punitive in nature." *Id.* at 307 (citing *Aro Mfg.*, 377 U.S. at 506) (emphasis in original). Based upon these principles, the court found that damage awards implicitly provide infringed-upon parties with "profits they would have received from sales absent the infringement--profits which would undeniably have been taxable as business income."[4] *Id.* at 308.

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[4] Petitioner erroneously maintains that the lower court misapplied this Court's opinion in *United States v. Safety Car Heating and Lighting Co.*, 297 U.S. 88 (1936), improperly relying upon it for its "in lieu of" analysis in determining that the damage award was apportionable. Petition p. 16. The court below, however, did not misapply this case, nor did it rely on the "in lieu of" theory in determining the income was constitutionally apportionable, as petitioner contends. The lower court simply found the "in lieu of" approach to be consistent with its interpretation and application of the statutory definition of business income, which was purely a matter of state law. Furthermore, the decision below properly relied upon 35 U.S.C. § 284 and this Court's opinion in *Aro Mfg.* for its "in lieu of" analysis.

Based upon the foregoing, the opinion properly concluded that North Carolina acted within its constitutional rights by classifying the Kodak judgment as business income and taxing it accordingly. *Id.* at 315.

B. The Opinion Below Is Consistent with This Court's Decision In *Allied-Signal*.

In arguing that the opinion of the North Carolina Supreme Court "conflicts in principle" with *Allied-Signal*,[5] petitioner misreads that decision. Petitioner contends that *Allied-Signal* "identified another way to characterize unitary business income: income from an *activity* that serves an operational function." Petition p. 9. Under *Allied-Signal*, however, the "relevant unitary business inquiry" focuses on whether the *asset* that produced the income served an operational function, and not, as petitioner maintains, whether the *activity* producing the income served an operational function:

> [T]he relevant unitary business inquiry, one which focuses on the objective characteristics of the asset's

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[5] In advancing its argument, Petitioner mischaracterizes the holding of the state court. Petitioner erroneously maintains that the opinion concluded that the income from the patent infringement lawsuit was apportionable "solely because the income 'stemmed from' patents that served some operational function. . . ." Petition p. 7. Petitioner confuses (as well as misstates) the court's analysis of the primary question before it--the interpretation of the statutory definition of business income--with the court's constitutional analysis.

> use and its relation to taxpayer and its activities within the taxing State[,] [is] whether in pursuing maximum profits [the taxpayer] treated particular intangible assets as serving, on the one hand, an investment function, or, on the other, an operational function.

Allied-Signal, 504 U.S. at 785.

The court below found that the particular intangible assets in question--the patents--were an integral part of Polaroid's business operations. Not only were the patents utilized in Polaroid's business activities in North Carolina, they were necessary for Polaroid to maintain its lawful monopoly in this market. As such, the patents were directly responsible for the sales made in this state and for the production of income from those sales. As the lower court recognized, "Polaroid's primary source of income results from the sale of products based upon its patents." *Polaroid*, 349 N.C. at 308. The patents served an operational function in Polaroid's business, part of which it conducted in this state. Taxation of the income from the patents therefore comports with *Allied-Signal.*

Moreover, *assuming arguendo* that *Allied-Signal* requires the actual activity, as opposed to the asset, to serve an operational function, Polaroid's protection of its fundamental business assets through the patent infringement lawsuit certainly performed an operational function; it sought to preserve Polaroid's monopoly and protect its market. In fact, defense of the patents was the quintessential defense of the

unitary business itself. When Polaroid defended the value of core assets necessary to carry on its unitary business through litigation, the income recovered from the party who damaged those assets necessarily constitutes income of the unitary business subject to apportionment.

C. This Case Presents No Important Federal Question.

Petitioner presents no important question of federal law which warrants review by this Court. Polaroid simply quarrels with the state court's interpretation and application of a statutory definition under state law, and its determination that, on the peculiar facts of this case, taxation of the damage award as "business income" is constitutionally permissible under the unitary business principle. As this Court has specifically recognized, however:

> If lower courts have reached divergent results in applying the unitary business principle to different factual circumstances, that is because, as we have said, any number of variations on the unitary business theme 'are logically consistent with the underlying principles motivating the approach,' and also because the constitutional test is quite fact-sensitive.

Allied-Signal, 504 U.S. at 785 (citation omitted).

This Court "will, if reasonably possible, defer to the judgment of state courts in deciding whether a particular set of activities constitutes a 'unitary business.'" *Container Corp.*, 463 U.S. at 175.

> It will do the cause of legal certainty little good if this Court turns every colorable claim that a state court erred in a particular application of those principles into a de novo adjudication, whose unintended nuances would then spawn further litigation and an avalanche of critical comment. Rather, our task must be to determine whether the state court applied the correct standard to the case; and if it did, whether its judgment was within the realm of permissible judgment.

Id. at 176 (internal quotations omitted).

Significantly, this Court has further noted that "not every claim that a state court erred in making a unitary business finding will pose a substantial federal question in the first place." *Id.* at 176, n.14.

This is just such a case.

Here, the state court found, as an evidentiary matter, that Polaroid failed to provide clear and cogent evidence that North Carolina's apportionment scheme resulted in extraterritorial values being taxed. The court further determined, under the

specific facts of this case, that the damage award from the patent infringement lawsuit constituted income earned from activities related to North Carolina, and that taxation was therefore proper under the unitary business principle. *Polaroid*, 349 N.C. at 314.

On the issue of fair apportionment, petitioner once again has the burden of proof. *See Container Corp.*, 463 U.S. at 180. This Court

> will strike down the application of an apportionment formula if the taxpayer can prove by clear and cogent evidence that the income attributed to the State is in fact out of all appropriate proportion to the business transacted in that State or has led to a grossly disproportionate result.

Id. at 170 (internal quotations and citations omitted).

In the proceedings below, petitioner made no attempt to claim the apportionment formula operated unfairly. The only "evidence" Polaroid now offers in support of this belated assertion is the fact that including the recovery in its apportionable income increased such income "eleven-fold." Of course Polaroid enjoyed a substantial increase in its apportionable income in the year it received the damage award. The recovery was designed to compensate Polaroid for the damages it had suffered over the past *fifteen years* as a result of Kodak's infringement. Any result *other than* a large increase

in apportionable income in the year the damages were received would be more probative of the distortion Polaroid alleges is present.

Moreover, there exists adequate relief under state law to remedy any perceived disproportionality in taxation, of which petitioner failed to avail itself. *See* N.C. GEN. STAT. § 105-130.4(t).[6] To the extent petitioner believed, as it now contends, that the apportionment formula operated to tax a greater portion of its income than was reasonably attributable to its business activity in this state, it should have filed a petition under state law seeking modification of the formula. *See Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 270 (1978).

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[6] This statute, which is similar to the adjustment provision under UDITPA, provides, in part, that:

> If any corporation believes that the method of allocation or apportionment as administered by the Secretary has operated or will so operate as to subject it to taxation on a greater portion of its income than is reasonably attributable to business or earnings within the State, it may file with the Tax Review Board a petition setting forth the facts upon which its belief is based and its argument with respect to the application of the allocation formula.

N.C. GEN. STAT. § 105-130.4(t)(1).

> The [state] statute afforded appellant the opportunity to demonstrate that the statutory formula produced an arbitrary result in its case. But this record contains no such showing and therefore the Director's assessment is not subject to challenge under the Due Process Clause.

Id. at 275. Here, too, the fact that Polaroid failed to avail itself of a state remedy affords additional grounds to deny its petition.

Petitioner also alleges that the state court erroneously concluded as a matter of law that the income received from Kodak was used as part of Polaroid's working capital.[7] Such a finding, however, constitutes a factual determination rather than a legal conclusion. Moreover, to the extent the determination of working capital presents a legal question, it constitutes at best an issue of state law rather than an important federal question warranting review by this Court.

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[7] The petition also erroneously states that "Polaroid did not use the recovery in the regular course of its business, for example, as working capital." Petition p. 4. The court found, however, that "the monies received from the Kodak lawsuit were used as part of Polaroid's working capital." *Polaroid*, 349 N.C. at 314.

II. THE PETITION PRESENTS NO IMPORTANT QUESTION OF FEDERAL LAW WHICH HAS NOT BEEN, BUT SHOULD BE, DECIDED BY THIS COURT.

A. The Issue Of What Income Can Constitutionally Be Included In The Apportionable Base Has Already Been Settled By This Court: The Unitary Business Principle Remains "the Linchpin Of Apportionability."

Petitioner creates, and then requests an answer for, its question of whether the scope of the Constitution's "proportionality rule" extends beyond the fairness of the apportionment formula and "also limits the pre-apportionment base to income derived from the regular course of the corporation's unitary business functions." Petition p. 14. What petitioner terms the "proportionality rule," however, is nothing more than the constitutional requirement that the apportionment formula be fair. *See Container Corp.*, 463 U.S. at 169.

Settled constitutional principles already adequately guard against a state's taxing income which cannot in fairness be attributed to the taxpayer's activities within the state. For example, *Mobil Oil Corp. v. Commissioner*, 445 U.S. 425, 437 (1980), requires that there be a rational relationship between the income attributed to the taxing state and the intrastate value of

the corporate business. *Mobil Oil* also prohibits a state from taxing a nondomiciliary corporation's income if it is derived from unrelated business activity which constitutes a discrete business enterprise. *Id.* at 442. Thus it is unnecessary for this Court to superimpose an additional, extraneous requirement, as petitioner urges, that income be earned in the "regular course" of the corporation's unitary business in order to be apportionable.

> [T]he unitary business rule is a recognition of two imperatives: the States' wide authority to devise formulae for an accurate assessment of a corporation's intrastate value or income; and the necessary limit on the States' authority to tax value or income which cannot in fairness be attributed to the taxpayer's activities within the State.

Allied-Signal, 504 U.S. at 780.

The limit upon the pre-apportionment base which petitioner contends is necessary is therefore already provided by the unitary business principle--the "linchpin of apportionability." *See Mobil Oil,* 445 U.S. at 439.

B. Petitioner's Proposal That The Court Superimpose An Additional Limitation On The Unitary Business Principle Constitutes Nothing More Than A Request That This Court Interpret A Statutory Definition Under State Law.

Petitioner asks this Court to find North Carolina's taxing scheme constitutionally flawed, contending that the lower court's interpretation of the statutory definition of business income to include a "functional test" inevitably results in disproportionate taxation.

Reduced to its essentials, in arguing that the decision below "removed a limitation on the scope of 'business income' that plays an important (if unexamined) role in insuring that income is not taxed out of all proportion to the income earned in the state," *see* Petition p. 14, petitioner simply asks this Court to restrict the state court's interpretation of the statutory definition of business income to the "transactional test." Although petitioner attempts to imbue the issue with constitutional overtones, this fundamental issue of state statutory construction presents a peculiarly inappropriate question for review.

Petitioner's suggestion that this Court revise its Due Process and Commerce Clause jurisprudence to impose the additional limitation that apportionable income must be earned

"in the regular course of business"[8] would substitute for established constitutional precedent one of the statutory tests for business income under the UDITPA definition.[9] In *Allied-Signal*, one of the amici had urged this Court to adopt as the constitutional test the entire UDITPA definition of business income. The Court, while noting that the definition may be quite compatible with the unitary business principle,

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[8] Petitioner incorrectly asserts that the UDITPA definition of business income "mandates that all income 'from' property such as taxpayer's be apportioned." Petition p. 12. UDITPA , however, only "mandates" that such income be classified as "business income" under the statutory definition for state law purposes. Whether or not such income is constitutionally apportionable is a separate, and subsequent, inquiry. Moreover, under the UDITPA definition, the income "from" property is classified as business income only if "the acquisition, management and disposition" of such property constitutes "integral parts of the corporation's regular trade or business operations." As this Court has noted, the UDITPA definition of business income may be quite compatible with the unitary business principle, which requires that the asset serve an operational as opposed to investment function in the taxpayer's business. *Allied-Signal,* 504 U.S. at 786.

[9] In contending that it did not receive the income from the litigation "from transactions or activities in the regular course of its trade or business," petitioner again intermingles the opinion's statutory analysis under state law with the relevant unitary business inquiry. It is true that the opinion below found, as a matter of statutory construction, that the income in question did not need to "arise from transactions and activities in the regular course of the taxpayer's trade or business," as that phrase has been interpreted in the context of the definition of business income, in order to constitute "business income" under the statutory definition. However, in addressing Polaroid's constitutional argument, the court in fact found that the "judgment from the Kodak lawsuit constitutes income earned from activities related to North Carolina." 349 N.C. at 314.

nevertheless declined to substitute it for what has become black letter law prompting substantial reliance interest by states and taxpayers alike regarding the unitary business principle. Petitioner asks this Court to engage in an even more radical departure--to adopt only one of the tests for business income as the predicate for apportionality under the Constitution, a request which this Court should similarly decline.

> Indeed, if anything would be unworkable in practice, it would be for us to now abandon our settled jurisprudence defining the limits of state power to tax under the unitary business principle.

Allied-Signal, 504 U.S. at 785.

C. The Constitution Does Not Require Mathematical Exactitude From An Apportionment Formula.

Petitioner contends its proposal that the Court limit apportionable income to that derived from the "regular course" of a corporation's unitary business is necessary because "only that series of transactions will consistently produce income that is logically related to the factors employed to apportion part of the unitary income to the taxing state." Petition p. 15.

This extraordinary rule proposed by Polaroid has no constitutional basis, however. As this Court has long

recognized, mathematical exactitude is not constitutionally required from an apportionment formula. *See, e.g., Illinois Cent. R. Co. v. Minnesota*, 309 U.S. 157, 161 (1940). Rough approximation rather than precision is sufficient. *Id.*

CONCLUSION

The Petition for Writ of Certiorari should be denied.

Respectfully submitted,

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